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CONTRIBUTION TO THE IMPROVEMENT OF THE FUNCTIONING OF COMMODITY MARKETS

Analysis of ways of improving the efficiency and use of existing mechanisms for the management of risks arising from commodity price fluctuations

Proposals of the Group of Experts on Commodity Exchanges*

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* The Group of governmental and nongovernmental experts convened by the Secretary-General of UNCTAD to examine (a) the conditions, both technical and regulatory, for encouraging maximum participation in, and usage of, commodity exchanges by both buyers and sellers of commodities and (b) proposals to address these conditions, pursuant to "A New Partnership for Development: The Cartagena Commitment", para. 213.

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PREAMBLE

1. The Group of Experts examined the technical and regulatory conditions for encouraging participation in, and usage of, commodity exchanges by both buyers and sellers of commodities using as a basis for their discussion the nine issues identified by the secretariat[1] and one additional issue on the development of new exchanges. The main findings emerging from their review are contained in the secretariat report to the Standing Committee on Commodities.[2] The Group concluded that well-functioning futures contracts are the most transparent and efficient mechanism for price discovery and risk sharing for internationally traded commodities as well as for commodities traded on domestic or regional markets and should be promoted where feasible. However, in practice, they are not a universally applicable solution and their potential role is necessarily limited by problems related to commodity characteristics, the low volume of trade for many commodities, market structure characteristics and market segmentation. The Group of Experts therefore noted that when a more structured market system, increased price transparency and risk sharing are objectives for commodity markets for which futures contracts are not viable, organized forward markets could be a possible option. Transferable forward contracts traded on an organized exchange are often a feasible way of providing price discovery and risk sharing at the national level. In addition, forward markets as well as well-functioning spot markets are usually important preconditions for the proper functioning of futures markets. The participation in, and usage of, commodity exchanges by buyers and sellers of commodities should be encouraged when specifications of contracts being traded are appropriate for their needs or objectives, and such use is not hindered by government policy conditions.

2. The Group of Experts agreed on several proposals which would help address the problem areas they identified in their review. The proposals are grouped under three headings: policy issues at the exchange/regulatory authorities level, national government level and international level, areas where further investigation are required and provision of training/advice/information. They stressed that these proposals are often interrelated and that follow-up actions should take into account these interrelationships.

3. The Group of Experts recommended that these proposals be communicated to and discussed with the various interested parties in order to stimulate these parties to undertake the actions suggested. They suggested that those contacted should include governments, regulators, futures industry associations, associations of buyers and sellers of commodities, accountancy and auditor representatives as well as appropriate educational institutes. In this regard, advantage should be taken of meetings of regulators, futures industry and commodity bodies of various sorts to promote consideration of the proposals. This task should be undertaken by the UNCTAD secretariat with assistance of Experts. The Group of

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[1] See UNCTAD/COM/16, "Technical and regulatory conditions influencing participation in, and usage of, commodity exchanges by both buyers and sellers of commodities" (Geneva, 22 April 1993), para. 2.

[2] TD/B/CN.1/10, "Analysis of ways of improving the efficiency and use of existing mechanisms for the management of risks arising from commodity price fluctuations" (Geneva, 27 August 1993).

Experts also recommended that an annual review of progress made in implementing its proposals be prepared and widely circulated and that there be a meeting in UNCTAD in two to three years time to assess progress made and to propose further steps to be taken.

A. POLICY PROPOSALS

4. The Group of Experts stressed that companies and other entities considering the use of commodity price risk management instruments have their own responsibilities including establishing an appropriate internal control mechanism for monitoring risk exposure and an appropriate accountancy system. They also need to ensure the continuity in the functions executed by persons trained in the use of risk management instruments. Companies should be encouraged to do so including through taking advantage of the training activities by various organisations - see section C. However, the policies of commodity futures exchanges (and regulatory authorities) as well as general government policies have a major influence on the possible use of risk management instruments. In this regard, the Group of Experts made a number of proposals to improve the conditions, both technical and regulatory, for encouraging participation in, and usage of commodity futures and options exchanges.

5. The Group of Experts recommended that all parties involved in the trade of a commodity be adequately represented on the governing body of the exchange trading a futures contract for that commodity as well as on its advisory bodies. Such parties include producers and consumers, traders, other intermediaries such as brokerage houses and banks, processors and non trade-related interests. It was also suggested that a governing body should include members representing the general public. Such a balanced representation can be achieved through action by a governing body in changing its statutes and/or co-opting members, or through appropriate government legislation.

6. The Group of Experts felt that while the existing consultation procedures for the formulation or modification of contract specifications were by and large adequate, not enough use was made of these procedures by interested parties with the consequence that contract specifications do not always reflect their needs. While contract specifications should reflect the concerns of commodity buyers in order that the quality of commodities being produced responds to that demanded, sellers have to date often not been sufficiently involved. The Group of Experts proposed that in order to help buyers and sellers, particularly those from developing countries and economies in transition, become more involved in contract development and modification procedures, exchanges and their members should undertake consistent and sustained efforts to make them aware of these procedures, of their importance, and of the ways of becoming involved. Such efforts could include distributing newsletters on contract specification issues. The Group noted that buyers and sellers can gain in influence in the formulation of contract specifications by becoming more active on futures markets, becoming members of exchanges, or, in the case of sellers, registering their products as deliverable against futures contracts. Exchanges with internationally traded contracts should strive to ensure that no major product origin is excluded from registration on grounds other than contract specification considerations.

7. The Group of Experts noted that there were attempts to manipulate futures markets. They felt that there was a problem with how manipulation was perceived. The Group noted that manipulation was generally not at such a level as to interfere with the participation in the market by buyers and sellers. On occasions, however, manipulation attempts do interfere with the orderly functioning of a contract. The following four proposals suggest ways to increase the confidence of market users:

(a) exchanges should to the extent possible reduce the opportunities for manipulation by encouraging broader-based participation in the trading of contracts and by ensuring appropriate delivery conditions including warehouse locations.

(b) Market users should be assisted in devising trading strategies which include ways of minimizing injury from manipulation attempts (see section C.1.iii).

(c) the rules and regulations concerning manipulation should be well-defined, strong, fair and transparent. In this regard

(i) the rules under which an exchange handles manipulation attempts should identify clearly the measures to be taken and be known to market users. A widespread publicizing of information on regulatory safeguards and standards of market behaviour would assist in this respect.

(ii) these rules should ensure that members of exchange committees dealing with manipulation cases do not have a conflict of interest of any sort.

(iii) the implementation of all rules concerning manipulation should be subject to close scrutiny by regulatory authorities.

(d) greater transparency on the functioning of futures market, including regulatory experience, and thus greater confidence in using them, could be achieved through periodic discussions in an international forum, which provide for an exchange of experience among buyers and sellers of commodities, including those not directly active on exchanges.

8. The Group of Experts noted that the concerns of regulatory authorities and exchanges regarding regulation of commodity contracts were different from those regarding regulation of securities or financial futures contracts and that regulatory standards differed widely from country to country. They encouraged greater world-wide consultation among exchanges and regulatory authorities concerning treatment of manipulation and other issues arising in the regulation of commodity contracts. Efforts should be made to disseminate the findings of such consultations more widely and in a more transparent manner.

9. The Group of Experts found that access conditions, including costs, of using commodity futures contracts could act as a significant barrier, notably to developing country users. In this regard, they proposed a number of policy measures oriented at coping with the financial implications of the use of commodity futures markets:

(a) on the issue of the costs and cash flow problems arising from the use of futures contracts:

(i) governments in developing countries and economies in transition, with support from the international trading community and international organizations, should stimulate the development of locally-based warehouses which can issue warehouse receipts. Such a system can provide the security necessary for credit lines to finance margin calls on domestic exchanges. Such warehouses can also help to institute national quality standards. When such warehouses are accredited by international exchanges they can also enhance the access to credit to finance margin calls on international exchanges;

(ii) bearing in mind relevant local conditions, these governments should help to improve the capacity of local financial institutions to provide credit lines to users of risk management instruments, through, for example, institution building or liberalizing access to foreign exchange, while refraining from direct subsidies. Assistance on how to implement appropriate policies, which will depend on the state of development of a country's financial sector, should be provided through the international community;

(iii) exchanges and exchange members should improve the information provided to their clients on possible ways of meeting margin calls, including the use of interest-bearing securities.

(b) Companies face significant organizational costs when setting up risk management activities, and are confronted with the responsibility to develop proper company control mechanisms. The Group of Experts suggested that direct substantive assistance to companies in this area be increased through the intermediation of commodity exchanges and their members. They felt that companies would also be helped if exchanges provided more information on their systems for monitoring the risk exposure of users.

10. The Group of Experts agreed that in several instances, a strong case could be made for the development of national or regional exchanges to support the strengthening of internal marketing for commodities, including those traded internationally. They stressed, however, that in order to do so difficult preconditions need to be met, especially in terms of attracting sufficient liquidity from trade and non-trade related interests, including speculators, and there is a need for enhanced technical and financial co-operation in these areas (see section C.3). The Group of Experts underlined that each proposal for a new exchange needed to be assessed on a case by case basis. They noted that different formats of an exchange should be considered, ranging from an independent open out-cry market, an electronic-based system, to the franchising of existing internationally traded contracts (trading such a contract in local hours and clearing it on the exchange of origin). Such proposals should take as a starting point local commodity industry needs rather than simply copying existing internationally-traded contracts.

11. The Group of Experts stressed that government policy makers have their own responsibilities in connection with the conditions for encouraging the functioning of, participation in, and usage of commodity exchanges. In this

respect, the Group suggested that governments take into account the following considerations:

(a) the policies of countries where commodity futures exchanges are located crucially influence the use of the exchanges. Such governments should try to ensure that their regulatory system for exchanges, taxation policy and foreign exchange regulations do not cause undue harm to the functioning of the exchange's contracts nor unnecessarily prevent the use of these contracts. Their trade policies should be compatible with the functioning of these contracts. In order to increase the awareness of governments of the possible impacts of their policies on the use of risk management instruments and to avoid certain actions which would adversely affect the use of these instruments, it was proposed to develop a series of basic guidelines for enabling legislation and economic policies which after international discussion at the exchange and regulators' level could be presented to the concerned governments for their endorsement. This work should be coordinated by UNCTAD in cooperation with other international organizations, on the basis of inputs from governments, regulators, buyers and sellers of commodities and other interested parties;

(b) the policies of all countries (both those with exchanges and those with only exchange users) influence the use that buyers and sellers of commodities can make of risk management instruments. Though not directly oriented at the use of these instruments, government policies such as foreign exchange regulations, taxation systems, accountancy rules, import and export regulations and price controls, as well as any other policy which impedes the proper functioning of the spot market, have major direct consequences on potential and actual users. Similarly, these and other policies can increase sovereign risks and reduce counterparty creditworthiness, thus reducing the access that companies have to international risk management markets. In this regard, it was noted in particular that price discovery on futures markets can be negatively affected by policies which hinder participation in such markets by countries important in the physical trade of a commodity. Governments should be aware of these implications, and take them into account when deciding on their policy actions. International organizations have started to provide governments with technical assistance on how to evaluate better the impact of their policies on the use of commodity exchanges, and such actions should be strengthened.

12. The Group of Experts recognized that governments, particularly of developing countries and economies in transition, have legitimate concerns regarding the use that local private or state companies can make of overseas risk management markets, in particular in terms of effects on foreign exchange reserves and fiscal revenue. Given that most governments have adopted policies on control of capital flows, the Group recommended the development of some guidelines to assist governments in minimizing the possible negative impacts of these policies on the legitimate use of risk management markets.

B. AREAS REQUIRING FURTHER INVESTIGATION

13. The Group of Experts agreed that there are three issues on which the information and analysis available at the present time is insufficient for the purposes of making recommendations. They suggested that in-depth studies should be undertaken at the international level with inputs from the private sector, regulatory authorities and the academic community.

14. As use of organized exchange markets as well as OTC markets is often hindered by creditworthiness problems, particularly for companies from developing countries and economies in transition, UNCTAD and other international organizations are urged to examine in-depth the various issues involved and possible ways to overcome them. Such issues include sovereign risks, foreign exchange regulations, accessibility of foreign exchange and access to credit lines, including for margin calls.

15. As an important degree of involvement of investment funds in commodity exchanges has occurred only recently, there is a need for more studies on the influence of their activity on price discovery, on the possible influence of the degree of their participation relative to that of other market users and on whether and under what conditions their involvement encourages or discourages use by buyers and sellers of commodities.

16. Information currently collected by exchanges or regulatory authorities on the structure of participation by main category of users (producers and consumers, intermediaries (trade houses), banks, investment funds, option market makers) is either not publicly available, incomplete or opaque. However, such information is essential for increasing the confidence of buyers and sellers in participating in or making use of commodity exchanges. International organizations (UNCTAD and the World Bank) should undertake work on reporting requirements with respect to the structure of market participation including a survey of existing systems and their limitations as well as suggestions on how this information could be made more useful to market participants. This work should be realistic and deal with information by user categories but not with company level data. It should be undertaken in close cooperation with exchanges and, when applicable, regulatory authorities.

C. TRAINING/ADVICE/INFORMATION

17. The Group of Experts stressed that among potential exchange users, senior company managers and government officials, in particular in developing countries and economies in transition, there was a widespread lack of understanding about the functions and uses of commodity exchanges and the requirements for and modalities of using them. This has led to misconceptions, lack of use or higher than necessary costs for those using the exchanges. The Group of Experts therefore proposed that existing training programmes and advice provided by international organizations, exchanges and others with expertise in this field be extended. They felt that training and advisory activities should be strengthened urgently in the areas of accounting, company control, and the characteristics of appropriate rules and regulations at the country level conducive to futures trading. Training should be provided at three levels: the

operational, the company management and the government level. The Group of Experts found that UNCTAD and the World Bank have a comparative advantage in focusing on the policy maker and company levels and that exchanges, the trading community and commodity organizations should contribute to training on technical issues for company managers and traders. Governments and companies should be encouraged to make optimal use of training possibilities. More information should be made available on a regular basis to these governments and companies about the availability of training possibilities.

18. A number of specific suggestions for training on technical issues were made including:

(a) those organizing training programmes should ensure that individuals directly involved in commodity trading who are to receive training on commodity futures markets possess a good understanding of physical trade practices or be first given training on these practices;

(b) programmes should specifically include training on how to operate under various market conditions, such as periods of high or low volatility, or periods of high or low volume of transactions;

(c) programmes should encompass information on accountancy and monitoring systems to support company management in controlling the use of risk management instruments;

(d) programmes should include advice and assistance on sources of market information, on how to evaluate this information and on how to build a network of reliable contacts for assessing the mood of the market.

19. Those organizing training programmes should ensure that government policy makers, Central Banks, the banking community and company treasury departments are addressed by these programmes with a view to raising their general awareness of the uses that can be made of commodity price risk management instruments as well as to providing them with the knowledge necessary to adapt their policies in this area.

20. International organizations should urgently provide governments of developing countries and economies in transition who deem it useful to extend their countries' involvement in commodity exchange trading, with advice and information on the identification and modification of national regulatory barriers (such as with respect to foreign exchange regulations, taxation systems, accountancy rules, price controls, and import and export regulations) which their buyers and sellers of commodities face when wishing to use risk management instruments. It was noted that such assistance should also address the need to cover currency risks linked to commodity transactions. The Group of Experts considered it useful for this purpose to assemble examples of rules and regulatory systems in individual countries and to develop a set of general principles. Advice and information provided should take into account the economic situation and institutional characteristics of individual countries rather than propose adopting a single system for all countries. Organizing training seminars which focus on an exchange of experience among governments on

how to develop country-level legislation governing use by its nationals of futures markets was considered a very useful activity in this respect.

21. The Group of Experts urged commodity exchanges, UNCTAD and other international organizations to study the problems involved in developing domestic and regional exchanges (including ways to bring existing exchanges up to the standard of internationally oriented ones), and to provide practical advice and information on the setting-up of new exchanges or alternative price formation mechanisms when appropriate.

22. The Group of Experts recommended that information on how various exchanges have maintained an orderly market, including in times of high volatility, be collated and disseminated.

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23. The Group of Experts recognized that the implementation of the activities outlined above, particularly those involving the provision of training and advice, has financial implications. They believed that programmes should, when appropriate, be cofinanced by beneficiaries. They also were of the view that international aid agencies, governments, exchanges and the international trading community should consider providing UNCTAD, World Bank and other international organizations with the necessary resources, both in financial terms and in terms of in-kind support, to support these activities.

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* Attended first meeting only (24 - 27 May 1993).
** Attended second meeting only (13 - 15 September 1993).
*** Confirmed invitation but unable to attend due to conflicting obligation